VAT in GCC countries

Tax in zero tax environment?

21 April, 2015

Disclaimer

NBAD

To the fullest extent allowed by applicable laws and regulations, National Bank of Abu Dhabi PJSC (the “Bank”) and any other affiliate or subsidiary of the Bank, expressly disclaim all warranties and representations in respect of this communication. The content is confidential and is provided for your information purposes only on an “as is” and “as available” basis and no liability is accepted for or representation is made by the Bank in respect of the quality, completeness or accuracy of the information and the Bank has undertaken no independent verification in relation thereto nor is it under any duty to do so whether prepared in part or in full by the Bank or any third party. Furthermore, the Bank shall be under no obligation to provide you with any change or update in relation to said content. It is not intended for distribution to private investors or private clients and is not intended to be relied upon as advice; whether financial, legal, tax or otherwise. To the extent that you deem necessary to obtain such advice, you should consult with your independent advisors. Any content has been prepared by personnel of the Global Markets at the Bank and does not reflect the views of the Bank as a whole or other personnel of the Bank

VAT (Value Added Tax) raises it's head… again

NBAD

- Unsurprisingly, with the recent drop in oil prices we are seeing the idea of introducing VAT in GCC countries raise it's head. However it is important to bear in mind that the concept of charging VAT in this region isn't new - GCC governments have been discussing the idea since 2007, following comments from international institutions such as the IMF etc .

- In GCC region, if the oil price were to stay at around say US$55, oil revenues are estimated to constitute 65% of government revenues and more importantly GCC region will register a fiscal deficit of circa 11%. This clearly indicates a very high reliance on oil revenues and as a result points to significant vulnerability (please refer to the data on slide 6).

- Hence given current macroeconomic conditions, GCC governments need to find other ways to broaden their revenue base away from oil and hence balance their fiscal budgets.

- IMF/World Bank reports and various public comments have suggested (some of them strongly) that GCC nations must remove existing subsidies (further details on slides 7-8) to reduce expenditure and introduce VAT to help support revenues as a way to deal with volatile oil prices and avoid having to deplete hard earned foreign asset reserves.

- Recently various committees have been established to investigate and analyze this matter, and indeed it was reported that there were talks at the end of February 2015 about the introduction of VAT in Doha, Qatar, and a rate of 4-6%has been discussed but not yet confirmed. In our view, *if* something like this were to go ahead, it would most likely not be a "blanket" VAT charge but perhaps levied as different rates for different types of products. There will be a ministerial meeting in May, in Qatar, where a proposal will be submitted to GCC ministers for their review.

Continued/-

So will it happen anytime soon?

In our view, it is highly unlikely - and hence the consumers among you can breathe a sigh of relief, for now at least. There are various reasons why we believe that GCC countries are unlikely to implement VAT in the near term - such as (i) diluting one of the region's key advantages of being viewed as a "zero tax" environment, (ii) the GCC nations having various other options open to them in terms of balancing the budget before having to resorting to more "traumatic" options such as the introduction of VAT, (iii) the possibly negative reaction from the population in some countries and the political implications of this, etc. We have provided a more detailed rationale for this conclusion later in this document.

Over the following pages we examine some of the factors mentioned above – impact of oil on the fiscal budgets of GCC countries, subsidies, etc – and provide more colour on our conclusions.

Some facts about VAT before we focus on the GCC perspective

- The system of Value Added Tax (VAT) was first proposed by Dr. Willhelm Von Siemens for Germany in 1919
- VAT has been adopted by around 150 countries in the world so far
- VAT is the main consumption tax system worldwide
- VAT contributes to approximately 20% of tax revenues where adopted
- Average VAT rate in the EU is around 20%
- Revenues from VAT are estimated to generate 7.5% of GDP globally

It is clear from the above that VAT is a tried, tested and indeed material component of fiscal revenues in many parts of the world. Whether it makes sense to introduce it here in the GCC remains to be seen.

The impact of lower Oil Prices for the GCC

- For the GCC countries as a whole, the oil price required for fiscal budgets to 'break even'(at 2015 planned expenditure levels) is circa US$85. Hence at the current oil price, a fiscal deficit of around 11% of GDP is estimated for the six countries collectively this year.

- GCC Nations are estimated to have about US$3 trillion in net foreign assets at present. In the past couple of years due to high level of oil prices these countries recorded substantial asset accumulation. However if we assume the oil price were to remain at say US$55 for the rest of the year, and no change in planned government spending, GCC nations could experience over US$200 billion of depletion in the collective net foreign assets in 2015 alone.

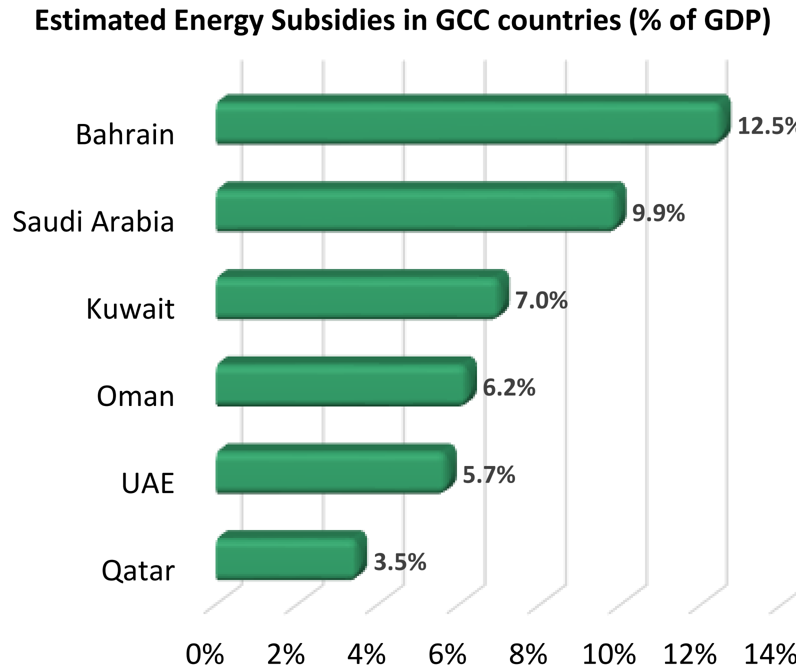
GCC (Oil Price Impact)							
	2012	2013	2014	2015 (F)			
Average Brent Price (US$)	111.55	108.44	97.52	45	55	65	75
Per Capita GDP (US$, 000)	32.33	32.45	31.53	25.09	26.36	27.64	28.91
Nominal GDP (US$ Billion)	1,577.71	1,639.19	1,648.86	1,356.81	1,425.17	1,494.25	1,562.91
Oil Sector GDP Weight (% share)	50.20%	49.17%	43.69%	23.08%	26.91%	30.81%	34.69%
Real GDP (% change y-o-y)	6	4.2	4	1.65	2.28	3.18	3.80
Oil Sector Gov. Revenue Weight (% share)	85.35%	83.09%	79.60%	54.54%	60.03%	65.26%	70.27%
Fiscal Balance (% GDP)	14.80%	10.20%	6.50%	-15.12%	-11.03%	-7.31%	-3.96%
Break-Even Oil Price (US$)	69	75	84	85			

Notes: (F) indicates forecast; Source: NBAD

Energy Subsidies in GCC (IMF & Moody's)

NBAD

A material component of Government expenditure across the GCC is direct energy subsidies. While data on this topic is somewhat patchy, the latest information published by the International Monetary Fund (IMF) shows the following:

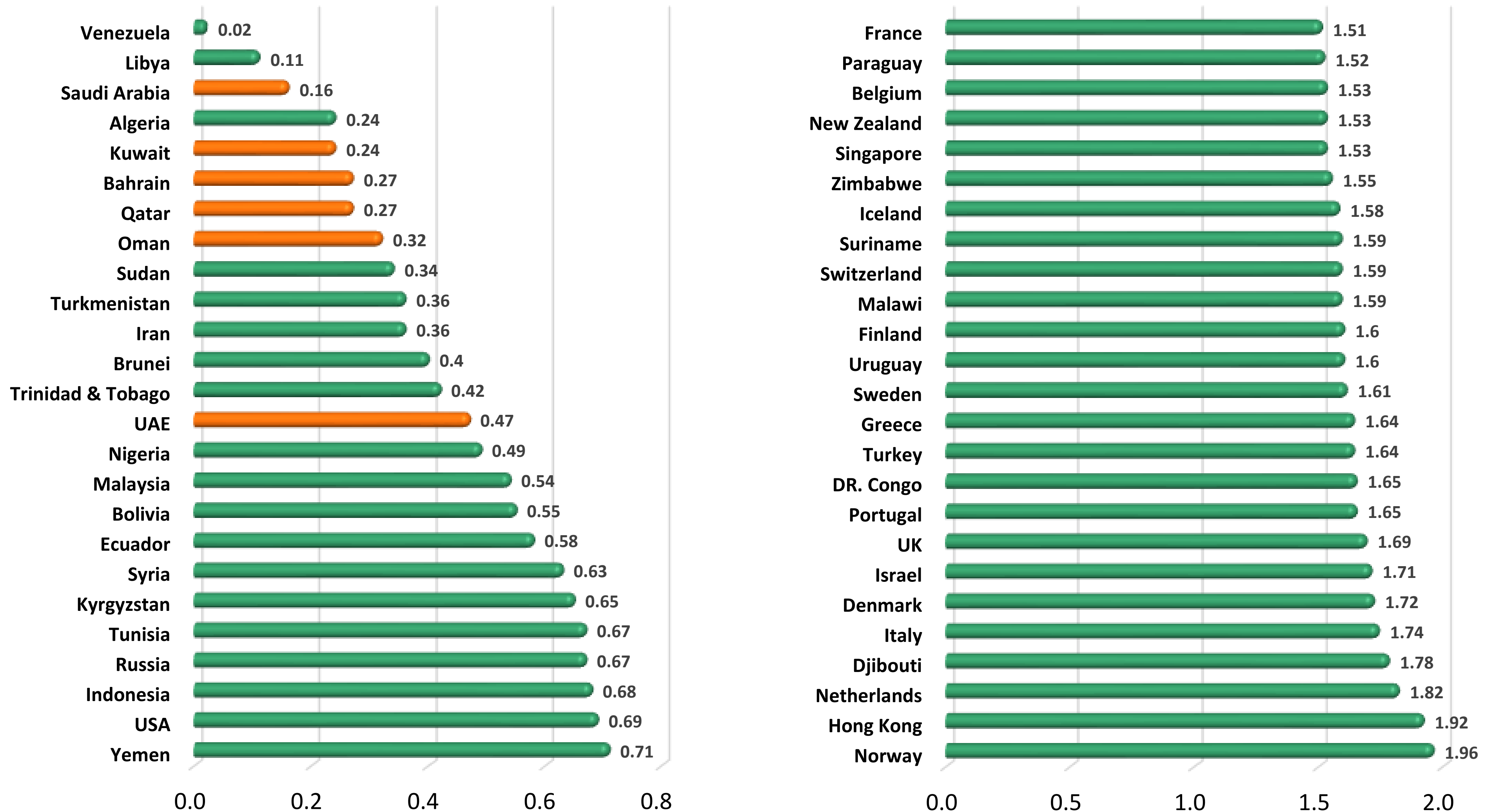


In fact earlier this year the IMF urged Gulf governments to reduce subsidies and other current spending (e.g. public sector wages) rather than cut capital expenditure and use assets.

To put these energy subsidies into context, and also in a manner that we can all relate to, please refer to the chart on slide 8 which shows recent "at the pump" gasoline prices across various countries around the world. We have shown the 25 highest and lowest prices, and have highlighted the GCC countries, just to put things into perspective.

Source: IMF; NBAD

Energy Subsidies in MENA Region



Source: IIF; NBAD

Is the GCC truly a "zero tax" environment at present?

Most people that live in this region would argue that it isn't a zero tax environment. While there may be no income tax for individuals, and for most companies no corporation tax, and indeed no VAT at present, there are various forms of levies and charges that can be regarded as "indirect taxation". For instance, in the UAE there are several such levies – some examples of which are shown below:

- UAE Airport Tax
- UAE Visa Fees
- In Dubai & Abu Dhabi, 5-10% is charged by the municipality on restaurant and hotel bills
- In Dubai municipal property tax levied on property owners - 10% of rental of commercial properties and 5% of rental in residential property. Abu Dhabi does not levy a municipality tax on rent but landlords are required to pay annual license fees.
- Dubai has a road toll system (SALIK) for its main highway - 4AED charge each time a car passes the toll gate
- Dubai Electricity and Water Authority (DEWA) also levies taxes on utility bills
- Dubai Land Department has introduced a property transaction fee of 4%
- Fees and charges for all ID cards, driving licences, visa renewals, health checks, etc.

In addition to the above, there are some – albeit limited – direct taxes such as the following:

Customs (import) duties are levied at a rate of 5% in general. Many items are duty exempt (i.e. medicines, most food products, raw material etc). Imports by free zone companies are also exempted unless products move outside the zone in which case customs duty is levied at 5%.

Bottom line: Will VAT be introduced in the GCC?

- In our view it is unlikely that GCC countries will implement VAT in the near term, due to the following reasons:

- While the drop in oil price has of course had a material and detrimental impact on the revenue side of the equation for all GCC countries, many of the nations concerned have committed to keeping planned expenditure unchanged, at least for 2015. That clearly poses an issue in terms of balancing their fiscal budgets.

- Notwithstanding the ability of these countries to sustain fiscal deficits in the short term, we would assume that looking further ahead they will need to find ways to balance their budgets if oil prices do indeed remain at relatively low levels for a prolonged period of time. But introducing VAT is far from being a simple solution to this budgetary issue. In fact we would argue that there are significant factors – such as those listed below - that would push it further down the list of preferred solutions in the eyes of the GCC Governments.

- VAT levied at any rate will reduce the competitiveness of GCC economies. One of the main pillars of the GCC's competitiveness and strong appeal to international investors is the "tax free" business-friendly environment making it a very attractive place to do business. Moving away from this would likely have a negative impact on sentiment towards the GCC in this context.

- The impact of a mild VAT would likely be totally different in the various GCC nations. For example Saudi Arabia, Oman and Bahrain are much more sensitive to VAT and reduction in consumer expenditure, while UAE, Qatar are more resilient.

Bottom line: Will VAT be introduced in the GCC? (cont'd)

- The introduction of VAT can certainly have political and social implications as well. For instance, the introduction of a low level of VAT in the UAE may create only minor dissent but in Saudi Arabia (where there is 12% unemployment) introduction of VAT soon after the accession will reduce political support for the new government and might cause significant public dissent. A similar reaction could happen in Oman & Bahrain as well. Kuwait does a have a parliamentary system, however VAT will likely not bode well with parliament members.

- Also, one should not underestimate the complexity of implementing VAT into economies such as those here in the GCC which have not administered and applied such taxes before. The mechanics of the system and administration involved are very extensive indeed, and furthermore it isn't just done at the Government level but virtually all businesses (large corporates to SMEs and small family businesses) would need to be educated in terms of how to apply the levy and more importantly how to account for the VAT and submit the regular reports and filings regularly to the Government. In this context, is the GCC ready for something like this?

- We understand that some of the GCC Governments have already undertaken studies to assess the financial impact of introducing VAT at a relatively low level such as 3-4%. The net incremental revenue from such an initiative, for a country such as the UAE, is estimated to be less than $10 billion. If this is indeed true, we would argue that it doesn't really make enough of a difference to warrant the effort that would be required to implement such a tax. In fact the negative sentiment generated by implementing VAT at this level would probably outweigh the financial benefits of doing so. In this case, why bother? Alternatively introduce VAT at a rate that generates a more meaningful level of income for the Government.

- In our view GCC countries are likely to look first at reducing expenditure before considering options such as the introduction of VAT. In this context, subsidies must be gradually reduced first, and then government spending on non-critical items, and later - if necessary – further expenditure cuts may be evaluated.

Bottom line: Will VAT be introduced in the GCC? (cont'd)

NBAD

- Actually we have already started to see reduction in subsidies in GCC. In first week of March, after serious warnings by IMF, the President of the Oman Central Bank announced that "Oman will cut/reduce natural gas subsidies later this year". Kuwait & Abu Dhabi also reduced subsidies on diesel, natural gas and utilities.

- ***Bottom line, GCC nations have other options available to them, hence VAT is unlikely to be introduced in the near term. Nevertheless, it is likely to remain on the radar so long as oil prices remain at these levels, along with other possible forms of taxation…***

Contact

Alp Eke – Senior Economist
Chavan Bhogaita
Rakesh Sahu

Market Insights & Strategy
NBAD
Tel: +971 2 6110 127
chavan.bhogaita@nbad.com